



A REPORT
TO THE
MONTANA
LEGISLATURE

FINANCIAL-COMPLIANCE AUDIT

Montana State Lottery
For the Two Fiscal Years Ended
June 30, 2011

MAY 2012

LEGISLATIVE AUDIT
DIVISION

10-30B

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Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2009, was issued March 1, 2010. The Single Audit Report for the two fiscal years ended June 30, 2011, will be issued by March 31, 2012. Copies of the Single Audit Report can be obtained by contacting:

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Angie Grove

May 2012

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report of the Montana State Lottery (Lottery) for the two fiscal years ended June 30, 2011. The report contains three recommendations to the Lottery. The recommendations address improvements needed in Lottery's control systems over contract monitoring and financial reporting.

The written response to the audit is included on B-1 of the audit report. We thank the director and her staff for their assistance and cooperation throughout the audit.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
Legislative Auditor

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APPOINTED AND ADMINISTRATIVE OFFICIALS

		<u>Term Expires</u>
Montana State Lottery Commission Members		
	Wilbur Rehmann, Chair	Helena 1/1/2013
	Craig Anderson, Dawson County Sheriff	Glendive 1/1/2013
	Thomas M. Keegan, Attorney at Law	Helena 1/1/2014
	Beth O'Halloran	Missoula 1/1/2014
	Leo Prigge, CPA	Butte 1/1/2015
Administrative Officials		
	Angela Wong, Montana State Lottery Director, effective February 7, 2011	
	George Parisot, Montana State Lottery Director, through December 30, 2010	
	John Tarr, Montana State Lottery Director of Security	
	Armond Sergeant, Financial Services Director	

For additional information concerning the Montana State Lottery, contact:

Armond Sergeant, Financial Services Director
 2525 N. Montana Ave.
 Helena, MT 59601
 (406) 444-5813
 e-mail: asergeant@mt.gov

MONTANA LEGISLATIVE AUDIT DIVISION

FINANCIAL-COMPLIANCE AUDIT

Montana State Lottery

For the Two Fiscal Years Ended June 30, 2011

MAY 2012

10-30B

REPORT SUMMARY

State law requires that a minimum of 45 percent of the money paid for tickets or chance must be paid out as prize money and that net revenue earned must be transferred to the General Fund. In fiscal year 2011, the Montana State Lottery transferred approximately \$10 million to the General Fund. The three findings in this report focus on improvements needed in the Lottery's control systems.

Context

The Montana State Lottery was approved in November 1986 by a referendum vote by the people of Montana to allow lottery games in which players purchase, through a state lottery, a chance to win a prize. A five-member Lottery Commission, whose members are appointed by the Governor, has certain powers and duties in law. State law also provides certain powers and duties to a director of the Montana State Lottery who is also appointed by the Governor.

This audit is the second audit that the Legislative Auditor has conducted; all others audits since the Montana State Lottery's inception were performed by private CPA firms through contracts with the Legislative Auditor.

The prior audit of the Montana State Lottery included six recommendations to the Montana State Lottery. We found the Lottery fully implemented five and partially implemented one recommendation.

Results

This audit report includes three recommendations to the Montana State Lottery. All three recommendations address areas we identified where the Lottery should improve its control systems related to contract monitoring and financial reporting.

Recommendation Concurrence	
Concur	3
Partially Concur	0
Do Not Concur	0

Source: Agency audit response included in final report.

For a complete copy of the report (10-30B) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to lad@mt.gov; or check the web site at <http://leg.mt.gov/audit>

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Chapter I – Introduction

Introduction

We performed a financial-compliance audit of the Montana State Lottery (Lottery) for the fiscal year ended June 30, 2011. The objectives of our audit were to:

1. Determine if the Statement of Net Assets, Statement of Revenues, Expenses and Changes in Fund Net Assets; and Statement of Cash Flows for the Lottery are fairly presented for fiscal year 2011 with comparative financial amounts for fiscal year 2010, in conformity with generally accepted accounting principles and state accounting policy.
2. Obtain an understanding of the Lottery's control systems as necessary to support our audit of the financial statements and, if necessary, make recommendations for improvement in management and internal controls of the Lottery.
3. Determine if the Lottery is in compliance with selected applicable state laws and regulations.
4. Determine the implementation status of prior audit recommendations.

This audit report includes three recommendations to the Lottery. In accordance with §5-13-307, MCA, we analyzed and disclosed the cost, if significant, of implementing the recommendations in this report.

Auditing standards require us to communicate, in writing, deficiencies in internal control we identified as a result of audit objective #2 above and considered to be significant or material. A deficiency in internal control exists when the design or operation of a control does not allow management or employees to prevent or detect and correct misstatements on a timely basis. A material weakness is one or more deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is one or more deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The following table identifies control deficiencies we identified during this audit.

Table 1 Summary of Deficiencies in Internal Controls			
Subject	Significant Deficiency	Material Weakness	Page
No documented contract monitoring controls	Yes	No	3
Inadequate controls over financial reporting	Yes	Yes	4

Source: Compiled by the Legislative Audit Division.

Background

The Lottery was approved in November 1986 by a referendum vote of the people of Montana. The general purpose is to allow lottery games in which players purchase from the State, through the administration of the Lottery, a chance to win a prize. A five-member Lottery Commission is provided for in state law. Members of the Commission are appointed by the Governor to four-year staggered terms. The director of the Lottery is also appointed by the Governor. Current games offered by the Lottery include scratch tickets, Powerball, Mega Millions, Montana Cash, Wild Card, Hot Lotto, 10 Spot, EZ Play, Fantasy Football, Fantasy Racing, and Montana Millionaire.

Lottery's operations are accounted for in an enterprise fund type, which means that its operations are financed and operated in a manner similar to private enterprise where the intent is to provide goods or services to the general public. State law requires that a minimum of 45 percent of revenue collected be used for prizes and that the Lottery transfer its net revenue to the General Fund. The Lottery receives no state funding.

The Lottery is a member of the Multi-State Lottery Association (MUSL), a nonprofit, government-benefit association. It is owned and operated by its member lotteries; each member lottery sits on the Board of Directors. Rules and regulations for all member state lotteries are developed by the board.

Prior Audit Recommendations

We performed the previous financial-compliance audit of the Montana State Lottery for fiscal year 2010 that included six recommendations to the Lottery. We found the Lottery has fully implemented five of the recommendations and partially implemented one. The one recommendation partially implemented relates to recording transactions in accordance with generally accepted accounting principles and providing training to accounting personnel. This recommendation is discussed beginning on page 5 of the report.

Chapter II – Findings and Recommendations

No Documented Contract Monitoring Controls

Montana State Lottery has not documented its existing controls to monitor contractor performance on the advertising contract.

Montana State Lottery (Lottery) administers three contracts that are integral parts of its operations: a gaming contract, a scratch ticket printing contract, and an advertising contract. Because these contracts are vital to Lottery's operations, we believe contract administration is a key business process. State accounting policy requires agencies establish, document, and monitor internal controls over key business processes. During the audit, we determined that Lottery has not documented its established controls for monitoring the advertising contractor's performance. Having its process documented would assist the Lottery in their responsibility to monitor the contractor to ensure it fulfills its obligations under the contract. Additionally, the documentation could help the Lottery in both its effort to pay the least amount possible for goods and services received through the contract and in its annual process to evaluate the contractor's performance.

The contract with the advertising firm specifies that Lottery is to pay a monthly retainer fee of \$11,805 for the services "customarily performed by a full-service advertising agency." Nearly all of the Lottery's advertising is procured through this contract. In fiscal year 2011, Lottery paid the contractor \$823,457 for advertising, advertising production expenses, and signs. This represents approximately one-third of the Lottery's nonpersonal services operating expenses for the year.

The Lottery paid approximately \$114,000 to the contractor for Lottery signs that were procured by the advertising contractor. Lottery personnel indicated that procurement of such signs was not a typical activity performed under the contract. The contract is silent in respect to such acquisitions; therefore, Lottery cannot be assured it was not over charged by the contractor. Had the Lottery procured the signs itself, under state purchasing regulations it would have had to obtain three bids and evaluate them to identify the lowest qualified bid. This bid requirement is designed to ensure the state government pays the least amount possible for goods of this value.

Given the broad nature of the service provided under the contract and the significant expense incurred through the contract, monitoring performance on the contractor is essential. While Lottery personnel were able to explain the procedure they currently use to monitor performance on the contract and the associated invoices for services, these controls are not documented as required by state accounting policy. Without

documentation of the essential monitoring controls determined to be necessary, the potential exists that critical components of the monitoring could be forgotten or neglected and go unnoticed. Documentation of monitoring controls, as well as the results of the monitoring, becomes even more critical when an organization experiences turnover, such as the Lottery has experienced recently. Additionally, having documentation of the results of its review of the contractor's performance could be a useful tool to the Lottery as it has to annually evaluate the contractor to make a decision on whether or not to extend the contract.

This changing environment increases the risk associated with contract performance and the risk that the Lottery may not timely identify potential performance or billing issues. For these reasons, it is important for the Lottery to document its established controls over the advertising contract as required by state accounting policy.

RECOMMENDATION #1

We recommend that the Lottery document its control system for monitoring the contractor's compliance with, and performance on, the advertising contract as required by state accounting policy.

Inadequate Controls over Financial Reporting

Section 17-1-102(4), MCA, requires state agencies to account for the receipt, use, and disposition of all public moneys on the state accounting system in accordance with generally accepted accounting principles (GAAP). The Department of Administration has established state accounting policy to guide agencies in recording transactions on the state's accounting system in accordance with GAAP. State accounting policy allows agencies to record encumbrances for commitments related to unperformed contracts for goods or services. Lottery personnel prepare both quarterly and annual financial statements that are intended to report its financial position and activity in accordance with GAAP.

The following two report sections discuss errors we noted in both the accounting records and financial statements, and improvements needed in its control system related to financial reporting.

Accounting Records

The Lottery recorded certain activity on the accounting records contrary to Generally Accepted Accounting Principles (GAAP) and state accounting policy.

The prior audit report contained a recommendation that the Lottery comply with state law by recording transactions in accordance with GAAP and provide accounting personnel training in the proper application of accounting policy and GAAP. Since the report was issued, Lottery has made strides to improve its compliance with state accounting policy. We noted increased awareness of state accounting policy requirements, as well as efforts to review and update accounting policies. In addition, we identified fewer and less serious accounting errors than those that were identified in the prior audit.

Below is a description of the errors we identified on the state's accounting system for fiscal year 2011.

- ◆ State accounting policy includes specific guidance that allows agencies to record an encumbrance on the accounting records for amounts owed for goods or services that have not yet been received by June 30. Lottery personnel did not record approximately \$100,000 of goods ordered but not yet received by June 30, 2011, as an encumbrance as required by state accounting policy. Instead, the Lottery recorded the item as an accrual, which is only allowed by state policy for goods received by June 30, 2011.
Lottery personnel indicated they were not familiar with the process used to record encumbrances on the accounting system. We noted that the Lottery's written control procedures regarding accounting for purchases do not include any instructions on the difference between encumbrances and accruals or a reference to the applicable state policy.
- ◆ At June 30, 2011, the Lottery had gaming machines worth approximately \$669,000 recorded on the accounting records as "work-in process inventory." State accounting policy defines this account as "...identifies the cost of uncompleted goods still in production containing appropriate amounts of the major manufacturing accounts—direct materials, direct labor and overhead." These machines do not meet this definition because they require only simple assembly and loading of software by their contractor.
Lottery personnel indicated the machines were recorded in the inventory account because they believed it was the proper account. We believe the machines clearly do not meet the definition of work-in process inventory and should have been recorded as equipment.
- ◆ During the fiscal year 2010 financial statement preparation process, Lottery posted a \$495,603 adjustment to decrease sales revenue and commission expense. Personnel did not record a corresponding entry on the state accounting system as required by state accounting policy. Department personnel indicated they did not believe a correcting entry was necessary because the error was only in nominal accounts.

Table 2 summarizes the misstatements on the accounting system from the three errors discussed on the previous page.

Table 2 Summary of Fiscal Year 2011 Misstatements		
Error Type	Account on the State Accounting System	Over/ (Understated)
Accrual Error	Encumbrance (Accrual)	\$(101,907)
Accrual Error	Expenditure Accrual	\$101,907
Gaming Machines	Inventory Work in Process	\$669,000
Gaming Machines	Equipment	(\$669,000)
Gaming Machines	Depreciation Expense	\$(133,900)
Gaming Machines	Accumulated Depreciation	\$(133,900)
Sales Adjustment	Sales Revenue, Program year 2010	\$495,603
Sales Adjustment	Commission Expense - 2010	\$495,603

Source: Complied by the Legislative Audit Division.

We found during fiscal year 2011 the Lottery made efforts to review and update its control policies regarding accounting transactions. However, we noticed the absence of any specific references into state accounting policy. Instructions exists in state accounting policy on many accounting issues, including the three issues discussed above related to accruals, account definitions, and correction of errors. We believe Lottery personnel need to become more familiar with state accounting policy to ensure transactions are recorded in accordance with state accounting policy and GAAP.

RECOMMENDATION #2

We recommend that the Lottery:

- A. *Become more knowledgeable in application of state accounting policy through training and by incorporating state accounting policy into its policies.*
- B. *Record accounting transactions in accordance with generally accepted accounting principles as required by state law and state accounting policy.*

Financial Statements

Controls over financial statement preparation process are not adequate to prevent or detect and correct financial statement errors on a timely basis.

The quarterly financial statements prepared by Lottery personnel are presented to the Lottery Commission and are distributed in accordance with state law to the Governor, Department of Administration, Legislative Auditor, President of the Senate, and Speaker of the House. The audited annual financial statements are included in the Lottery's annual report and a draft is sent to Department of Administration to assist in the presentation of the Lottery's activity in the state's financial statements. Given the wide-spread distribution of the quarterly and annual financial statements, we believe financial statement preparation is a key business process. State accounting policy requires agencies to establish, document, and monitor internal controls, and it also requires that all year-end financial statement adjustments be fully documented.

Both the quarterly and annual financial statements are prepared by personnel by starting with the Lottery's activity recorded on the state's accounting system. We believe their control systems over this process are not adequate to prevent or detect and correct, on a timely basis, errors made in the process. Below we discuss three errors we noted in the financial statements that were provided to us for the audit, as well as control issues we identified in the financial statement preparation process.

Financial Statement Errors

As discussed in the previous report section, we identified and discussed with Lottery personnel an error in recording an expenditure encumbrance of approximately \$100,000 on the accounting system. The purchase was recorded in error as an accrual instead of an encumbrance. Despite the fact that Lottery personnel agreed with us that it should have been an encumbrance, they did not initially agree that it should not be included as a liability and expense on the Lottery's financial statement. Lottery personnel stated that the liability and related expense should be included in the financial statements to be conservative. State accounting policy is clear that encumbrances are for budgetary purposes only and should not be included on GAAP financial statements.

The second error involves Lottery's presentation of capital assets net of related debt on its financial statement that is inconsistent with requirements in state accounting policy. Lottery personnel did not include lease obligations associated with capital equipment as required after consultation with personnel at Department of Administration. After subsequent discussions, Lottery personnel made an adjustment to the financial statements.

Lastly, we noted Lottery personnel initially included depreciation expense from a prior period in the 2011 column of the financial statement that was already included in the 2010 column. After we brought the error to their attention, Lottery personnel removed the depreciation from the depreciation expense line and reported it as a prior-period adjustment in the 2011 column. Governmental Accounting Standard Board guidance notes that a prior-period adjustment should only be presented if the beginning net assets are misstated as a result of an error in a prior year. Because Lottery had already included the depreciation expense in the 2010 column, the beginning net assets were not misstated. As such, the prior-period adjustment line was not necessary. After discussing this issue with Lottery personnel, an adjustment was made to the financial statements.

Financial Statement Preparation Controls

In addition, we noted the following control issues in the financial statement process itself:

- ◆ Procedures for preparing the financial statements are not fully documented.
- ◆ Several adjustments made to the financial statements were not sufficiently documented to explain the process and/or the reason for the adjustments.
- ◆ A single Lottery employee prepares the financial statements, there is no review of the financial statements by someone else with a background in state accounting policy, GAAP, and financial reporting. Lottery does not have personnel qualified for this type of review. However, Lottery is part of the Department of Administration, which has several personnel qualified to do this type of review. We believe some of the errors we found may have been detected by this type of a review.

Some of the errors we detected in the financial statements may have been prevented or detected and corrected on a timely basis by a more complete and documented financial statement preparation control system. The control system should include a comprehensive checklist of all items to consider when preparing the finance statements. A review of the financial statements by someone qualified is a control that Lottery personnel should consider to strengthen their control system. Documentation of the process itself would provide continuity in case of turnover and allow for a more critical evaluation of the control process.

RECOMMENDATION 3

We recommend the Lottery:

- A. *Document its financial statement preparation controls as required by state accounting policy, and*
- B. *Strengthen its financial statement preparation control system to prevent or detect and correct errors on the draft financial statements on a timely basis.*

**Independent Auditor's Report and
Montana State Lottery
Financial Statements**

LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
 Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors
 Cindy Jorgenson
 Angie Grove

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
 of the Montana State Legislature:

We have audited the accompanying Statement of Net Assets of the Montana State Lottery as of June 30, 2011, and 2010, and the related Statement of Revenues, Expenses and Changes in Fund Net Assets, and Statement of Cash Flows for each of the fiscal years then ended. The information contained in these financial statements is the responsibility of Montana State Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the enterprise fund of the Montana State Lottery and do not purport to, and do not, present fairly the financial position of the state of Montana as of June 30, 2011, and 2010, and the related changes in its financial position or cash flows for each of the two years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Lottery as of June 30, 2011, and 2010, and its changes in net assets and cash flows for the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

/s/ Cindy Jorgenson

Cindy Jorgenson, CPA
 Deputy Legislative Auditor

March 23, 2012

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**MONTANA LOTTERY
STATEMENT OF NET ASSETS
JUNE 30, 2011 AND 2010**

	2011	2010
		(restated)
ASSETS:		
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 2,717,838	\$ 2,995,655
Receivables (Net)	1,825,263	1,786,398
Inventories	367,625	528,373
Securities Lending Collateral	29,168	45,616
Prepaid Expenses	<u>27,175</u>	<u>90,497</u>
TOTAL CURRENT ASSETS	4,967,069	5,446,539
NONCURRENT ASSETS		
Computer, Furniture & Equipment	2,415,766	1,460,176
Leasehold Improvements	45,448	45,448
Equipment - Work in Process	669,500	0
Receivable - Equipment	0	1,625,000
Accumulated Depreciation	(725,205)	(456,052)
Investments	37,214	71,375
Multi-State Reserve fund	<u>1,688,570</u>	<u>1,430,386</u>
TOTAL NONCURRENT ASSETS	4,131,293	4,176,333
TOTAL ASSETS	\$ 9,098,362	\$ 9,622,872
 LIABILITIES:		
CURRENT LIABILITIES		
Accounts Payable	\$ 368,716	\$ 612,584
Estimated Prize Liability	1,731,441	2,570,063
Transfer Obligations	2,892,772	2,467,133
Liability under Security Lending	29,168	45,616
Deferred Revenue	131,262	137,757
Accrued Compensated Absences	129,540	108,283
Current Portion Long-Term Obligations	<u>72,168</u>	<u>72,168</u>
TOTAL CURRENT LIABILITIES	5,355,067	6,013,604
NONCURRENT LIABILITIES		
Multi-State Prize Liability	1,525,857	1,223,060
Accrued Compensated Absences	69,629	118,550
Long Term Obligations	270,629	342,797
Other Post Employment Benefits	<u>395,337</u>	<u>299,861</u>
TOTAL NONCURRENT LIABILITIES	2,261,452	1,984,268
TOTAL LIABILITIES	7,616,519	7,997,872
NET ASSETS		
Invested in Capital Assets, net of related debt	2,062,712	1,120,947
Unrestricted Net Assets	<u>(580,869)</u>	<u>504,053</u>
TOTAL NET ASSETS	1,481,843	1,625,000
TOTAL LIABILITIES AND NET ASSETS	\$ 9,098,362	\$ 9,622,872

The accompanying notes are an integral part of these financial statements.

MONTANA LOTTERY
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN FUND NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

	2011	2010
OPERATING REVENUES:		
Scratch Ticket Revenue	\$ 15,064,556	\$ 14,274,286
On Line Ticket Revenue	30,975,226	32,578,512
License, Permits, and Misc	8,450	20,661
Total Operating Revenues	46,048,232	46,873,459
DIRECT GAME COSTS:		
Scratch Ticket Prize Expense	8,990,017	9,361,059
On Line Ticket Prize Expense	15,787,901	16,580,066
Retailer Commissions	2,716,363	2,338,036
Cost of Tickets Sold	1,059,590	1,193,018
Vendor fees	2,759,777	2,811,246
Total Direct Game Costs	31,313,648	32,283,425
Income Before Operating Expenses	14,734,584	14,590,034
OPERATING EXPENSES:		
Advertising	638,550	617,438
Advertising Production	249,447	429,878
Audit Fees	36,757	71,160
Bad Debts Expense	382	3,546
Communications	131,321	83,752
Contractual Services	106,444	203,802
Depreciation and Amortization	269,154	161,934
Interest	21,987	0
Administrative Service Fee	66,685	64,460
Multi-State Dues	45,530	47,973
Public Relations	34,414	51,448
Other Post Employment Benefits	95,476	83,673
Other Expenses	33,945	63,268
Personal Services	1,834,607	1,818,562
Repairs and Maintenance	18,539	20,429
Supplies and Materials	287,945	161,597
Travel	39,928	56,002
Utilities and Rent	154,956	139,054
Total Operating Expense	4,066,067	4,077,976
Operating Income	10,668,517	10,512,058
NONOPERATING REVENUES (EXPENSES):		
Interest Earnings	8,296	16,333
Security Lending Income	1,292	1,203
Security Lending Expense	(274)	(406)
Gov FA Disp Proceeds	0	686
Gain/Loss on Sale of Assets	0	(2,953)
Capital Contribution - Non State	0	1,625,000
Total Nonoperating Revenues(Expenses)	9,314	1,639,863
Income Before Operating Transfers	10,677,831	12,151,921
Operating Transfers Out - General Fund	(10,820,988)	(10,526,921)
CHANGE IN NET ASSETS	(143,157)	1,625,000
Total Net Assets, Beginning of Period	1,625,000	0
TOTAL NET ASSETS, END OF PERIOD	\$ 1,481,843	\$ 1,625,000

The accompanying notes are an integral part of these financial statements.

MONTANA LOTTERY
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

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	2011	2010 (restated)
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for Sales & Services	\$ 46,002,490	\$ 46,314,363
Payments for Goods & Services	(8,400,079)	(7,791,473)
Payments to Employees	(1,862,271)	(1,802,797)
Payments for Prizes	<u>(25,313,743)</u>	<u>(24,828,183)</u>
Net Cash Provided by Operating Activities	<u>10,426,397</u>	<u>11,891,910</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Transfer to Other Funds	<u>(10,395,349)</u>	<u>(10,596,118)</u>
Net Cash Used For Noncapital Financing	<u>(10,395,349)</u>	<u>(10,596,118)</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of Fixed Assets	0	(565,149)
Proceeds from Sale of Fixed Assets	0	687
Principal & Interest Payment on Leases	<u>(94,155)</u>	<u>0</u>
Net Cash Used For Capital Financing	<u>(94,155)</u>	<u>(564,462)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest and Dividends on Investments	9,314	17,130
Received from (Paid to) MUSL Prize Reserve Fund	(258,184)	333,398
Sale (Purchase) of long term investments	<u>34,160</u>	<u>67,898</u>
Net Cash Provided (Used) by Investing Activities	<u>(214,710)</u>	<u>418,426</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(277,817)	1,149,756
CASH AND CASH EQUIVALENTS, JULY 1	<u>2,995,655</u>	<u>1,845,899</u>
CASH AND CASH EQUIVALENTS, JUNE 30	\$ <u>2,717,838</u>	\$ <u>2,995,655</u>
Reconciliation of Operating Income to Net Cash Provided by Operating Activities		
Operating Income	\$ 10,668,517	\$ 10,512,058
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities		
Depreciation	269,154	161,934
Interest Expense	21,987	0
Change in Assets and Liabilities:		
Decr (Incr) in Account Receivable	(38,865)	(441,459)
Decr (Incr) in Due from Other Funds	0	1,015
Decr (Incr) in Inventories	160,748	266,667
Decr (Incr) in Collateral securities on loan	16,448	64,228
Decr (Incr) in Prepaid expenses	63,322	337,437
Incr (Decr) in Accounts Payable	(243,958)	(43,016)
Incr (Decr) in Lottery Prizes Payable	(535,825)	1,112,942
Incr (Decr) in Liability for securities on loan	(16,448)	(64,228)
Incr (Decr) in Deferred Revenue	(6,495)	(115,106)
Incr (Decr) in Other Post Employment Benefits	95,476	83,673
Incr (Decr) in Compensated Absences Payable	<u>(27,664)</u>	<u>15,765</u>
Total Adjustments	<u>(242,120)</u>	<u>1,379,852</u>
Net Cash Provided by Operating Activities	\$ <u>10,426,397</u>	\$ <u>11,891,910</u>
Schedule of noncash transactions:		
Capital Contributions - Non State	\$ 0	\$ 1,625,000
Total noncash transactions	<u>0</u>	<u>1,625,000</u>

The accompanying notes are an integral part of these financial statements.

MONTANA LOTTERY
Notes to the Financial Statements
June 30, 2011

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity.

The Montana Lottery, established under the provisions of Section 23-7-101, Montana Code Annotated (MCA), was approved by the Montana electorate through Legislative Referendum No. 100 on November 4, 1986.

Montana's first lottery tickets went on sale June 24, 1987.

The Montana Lottery is operated by a five-member commission consisting of Montana residents appointed by the Governor. The Commission, by law, has the power to operate a state lottery, determine the types and forms of lottery games, set the ticket price, number and size of prizes, conduct lottery drawings, enter into agreements to offer lottery games in conjunction with other lottery states and countries, and prepare financial reports. The Montana Lottery is attached to the Montana Department of Administration for administrative purposes.

The Montana Lottery is included as an enterprise fund in the State of Montana's Comprehensive Annual Financial Report. In accordance with governmental accounting and financial reporting standards, there are no component units to be included within the Montana Lottery's financial statements as a reporting entity.

Basis of Presentation. The Montana Lottery reports its financial activity in accordance with generally accepted accounting principles (GAAP) as prescribed in pronouncements of the Governmental Accounting Standards Board (GASB).

Enterprise Fund. The Montana Lottery is classified as an Enterprise Fund of the Proprietary Fund Type. Enterprise Funds account for operations: a) financed and operated similar to private business enterprises, where the intent of the Legislature is that costs are to be financed or recovered primarily through user charges, or b) where the Legislature has decided that periodic determination of revenue earned, expenses incurred, or net income is appropriate.

Basis of Accounting. The Montana Lottery's financial statements are prepared using the accrual basis of accounting. Revenues are recognized in the accounting period in which they are earned and become measurable; expenses are recognized in the period incurred, if measurable.

Property and equipment. Property and equipment are recorded at cost. Donated property and equipment are recorded at their estimated fair market value at the date of donation. Ordinary maintenance and repairs are charged to operations as incurred; major renewals and betterments are capitalized. Upon disposition or retirement of property and equipment, the cost and related accumulated depreciation or amortization are removed from the accounts. Gain or loss on disposal is reflected in non-operating revenues and expenses. Depreciation and amortization are calculated on a straight-line basis over estimated useful lives of three to ten years. The Lottery conforms to the State of Montana capitalization threshold for capitalizing property and equipment as well as buildings and building/land improvements. The threshold for capitalizing property and equipment is \$5,000 and the threshold for capitalizing buildings/land improvements is \$25,000.

Revenue Recognition. Lottery scratch ticket sales are recorded as revenue based on the time the retailer activates the pack of tickets for sale. In accordance with an established policy, retailers may return unsold tickets to the Lottery for credit. Sales are decreased by an allowance for estimated ticket returns.

Ticket sales for lotto games Powerball, Wild Card, Montana Cash, Hot Lotto, Montana Millionaire, Mega Millions, and 10 Spot are recorded as revenue based on drawings. Tickets sold in advance for future drawings are recorded as deferred revenue until such time as the tickets become valid for the most current drawing.

Ticket sales for Fantasy Sports games are based upon MCA 23-4-302 and an interagency agreement between the Lottery and the Board of Horse Racing.

Classification of Revenues. The Lottery has classified its revenues as either operating or non-operating according to the following criteria:

Operating revenues – include activities that have characteristics of exchange transactions, including (1) ticket sales, net of returns, and (2) retailer license fees and administrative fees in relation to selling lottery tickets.

Non-Operating revenues – include activities that have the characteristics of non-exchange transactions, such as gifts and other revenue sources that are defined as non-operating revenues by GASB No. 9, “Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting,” and GASB No. 34, “Basic Financial Statements and Management Discussion and Analysis for State and Local Governments.” Types of revenue sources that fall into this classification are state appropriations, investment income, and gain or loss on disposition of assets.

Free Tickets. Some Montana Lottery scratch games award free tickets as prizes. Net lottery ticket revenue does not include the value of free tickets given away and free plays won. The face value of these free ticket prizes distributed for the quarter and twelve months ended June 30, 2011 was \$75,668 and \$351,755, respectively.

Promotional Credits. The Lottery issues promotional credits to retailers to be used to distribute free tickets to players. The tickets are distributed as part of a promotion run by the retailer, e.g., "Ask for the Sale" or second chance drawings. The Lottery also directly distributes scratch tickets for promotional purposes at trade shows, for media give-aways, and during new game introductions. The tickets distributed as a result of promotional credits are reflected as a reduction in revenue. The related prize expense and ticket cost for all promotions are reclassified as an advertising expense. For the quarter ended June 30, 2011, promotional credits resulted in a revenue reduction of approximately \$4,714 and an expense reclassification of approximately \$3,574. For the twelve months ended June 30, 2011, promotional credits resulted in a revenue reduction of approximately \$35,508 and an expense reclassification of approximately \$27,273.

Prizes. Expenses for scratch prizes are recorded based on the predetermined prize structure for each game. Expenses for lotto prizes are recorded based on the predetermined prize structure for each individual game. No prize expense is recorded for free tickets distributed.

Unclaimed Prizes. Prizes for the lotto games must be claimed within six months after the appropriate draw date. Prizes for scratch games must be claimed within six months of the announced end of each game. The unclaimed prize amounts for the Montana Lottery lotto games are taken as a reduction in the Lottery Prizes Payable liability and the Prize Expense and are transferred to the State of Montana General Fund as a portion of the quarterly transfer. The amount of unclaimed prizes for all Montana Lottery games is represented in the table below.

	Quarter Ended 6/30/11	Quarter Ended 6/30/10	Year To Date 6/30/11	Year To Date 6/30/10
Lotto	\$122,792	\$130,731	\$694,034	\$543,364
Scratch	\$306,181	\$134,468	\$683,781	\$402,006
TOTALS	\$428,973	\$265,199	\$1,377,815	\$945,370

Reclassification and Restatement. In order to make certain prior year amounts compare to the current year presentation on the Statement of Net Assets, \$414,965 of a lease was reclassified from Accounts Payable and broken up between current and noncurrent liabilities. The statement now reflects \$72,168 in Current Portion Long-Term Obligations, and \$342,797 in Long Term Obligations. In addition, \$69,197 was reclassified on the Statements of Cash Flows from operating activities to noncapital financing activities. This reclassification better reflects the actual cash flow for transfers to the General Fund.

2. SUMMARY OF ACCOUNTS

Cash and Cash Equivalents. Cash and cash equivalents consist of interest-bearing deposits with the Montana Board of Investments short-term investment pool, cash on deposit in revolving account with a non-state financial institution and cash on deposit with the Montana State Treasurer that is part of the State's pooled cash and is not separately identifiable as to specific types of securities. These funds are highly liquid and may be drawn on daily.

Cash and cash equivalents consist of the following:

	June 30,	
	<u>2011</u>	<u>2010</u>
Short-term investment pool	\$2,154,658	\$1,112,340
Cash on deposit with State Treasurer	553,130	1,876,708
Cash in revolving deposit account	10,000	5,284
Petty Cash & Cash on Hand	50	1,323
TOTALS	\$2,717,838	\$2,995,655

The bank balance of the revolving deposit account, not including outstanding deposits or checks, was \$27,423 at June 30, 2011 and was covered by federal depository insurance. The carrying amount reported in the balance sheet for cash and cash equivalents approximates the fair market value.

Receivables. Receivables include \$2,039,454, representing amounts due the Lottery for tickets purchased by retailers. Receivables also include \$670 for interest income due from the Montana Board of Investments short-term investment pool. An allowance for ticket returns is included in the receivables amount. This allowance represents a reduction in receivables at June 30, 2011, for estimated ticket returns. This is an estimate based on returns received to date, as well as an estimate of tickets unsold by retailers for games that have a public sale end date prior to July 1, 2011. The allowance for ticket returns is \$228,090 at June 30, 2011. The return of vendor fees related to the allowance for returns is \$13,229.

Inventories. Inventories consist of merchandise and supplies inventories. Merchandise inventory includes scratch tickets valued at \$313,654 stored in the warehouse, at retailers prior to being activated by the retailer, and with the marketing representatives. These ticket inventories are recorded at cost using the specific identification method and maintained on a perpetual inventory system. Tickets are charged to cost of tickets sold upon activation or after game end.

Supplies inventories include ticket dispensers, premiums and point-of-sale materials. At year end, supplies inventories totaled \$53,971. These inventories are also recorded at cost using the specific identification method.

Other Current Assets. Other current assets include the following:

	June 30,	
	2011	2010
Prepaid Expenses	\$27,175	\$90,497

The prepaid expense amount consists of \$13,000 for booth fees for upcoming summer fairs, and \$14,175 for prepaid commissions and vendor fees related to deferred revenue.

Property and Equipment. A summary of property and equipment for the Lottery is as follows:

	June 30, 2010	Additions	Deletions	June 30, 2011
Leasehold Improvements	\$ 45,448	\$ -	\$ -	\$ 45,448
Furniture & Equipment	\$ 1,460,176	\$ 955,590	\$ -	\$ 2,415,766
Accumulated Depreciation	\$ (456,052)	\$ (269,153)	\$ -	\$ (725,205)

Receivable – Equipment. The equipment receivable by the Lottery of \$1,625,000 was for 250 on-line vending machines due from the Lottery's primary vendor on June 30, 2010.

Estimated Prize Liability. The estimated prize liability represents the Lottery's estimate of prizes payable related to games in process at year-end based on the predetermined prize structure of each outstanding game.

Obligation to Transfer Funds. The Lottery is required to transfer its net revenue to the Montana State General Fund. This change was enacted through the passage of SB83 by the 1995 Legislature and signed into law by Governor Racicot in April 1995. The transfer obligations outstanding at June 30, 2011 and 2010 were \$2,892,772 and \$2,467,133, respectively.

Compensated Absences. State employees earn vacation leave ranging from 15 to 24 days per year depending on the individual's years of service. Vacation leave may be accumulated not to exceed two times the maximum number of days earned annually. With no limit on accumulation, sick leave is earned at 12 days per year. Upon retirement or termination, an employee is paid 100% for unused vacation and 25% for unused sick leave. The Lottery's liability for compensated absences is detailed below.

Balance June 30, 2010	Net Leave Earned/(Used)	Balance June 30, 2011
\$226,833	\$(27,664)	\$199,169

OPEB (Other Post Employment Benefits) Implicit Rate Subsidy LT. Effective for Fiscal Year End 08, GASB Statement 45 and the reporting requirements for the "implied rate subsidy" required the State of Montana to book substantial liabilities. The liability is a result of the state's requirement to allow retired employees to remain in the retirement plan after retirement. This results in an implicit rate subsidy since retirees pay the same amount as active employees. "Actuaries Northwest" prepared the report for the State of Montana to calculate the Annual Required Contribution under the Governmental Accounting Standards Board (GASB). The allocation is made based on the fiscal year's benefits expense and the number of full time employees for an agency.

The Lottery's OPEB obligations for 2011 and 2010 are as follows:

Year ended June 30,	2011	2010
Annual Required Contribution	\$ 95,476	\$ 83,673
Adjustment to annual required contributions	-	-
Annual OPEB cost	\$ 95,476	\$ 83,673
Contributions made	-	-
Increase to net OPEB obligation	\$ 95,476	\$ 83,673
Net OPEB obligation – beginning of year	<u>\$ 299,861</u>	<u>\$ 216,188</u>
Net OPEB obligation – end of year	<u>\$ 395,337</u>	<u>\$ 299,861</u>

Commissions. Section 23-7-301(10), MCA, provides retailers a commission on scratch and lotto tickets or chances sold. The Lottery Commission established this commission at 5% of the face value of scratch tickets activated by the retailers and the face value of lotto tickets sold. Section 23-4-302 (5)(b)(i), MCA establishes a 3.99% commission of the face value of Fantasy Sports tickets sold. In addition retailers can earn bonus commissions on tickets sold based on incremental sales of scratch tickets. For the quarter and twelve months ended June 30, 2011 retailers earned bonus commissions of \$81,035 and \$405,355,

respectively. For the quarter and twelve months ended June 30, 2011 total commissions were \$616,903 and \$2,716,363, respectively.

3. PAYMENTS TO OTHER STATE AGENCIES

The Lottery receives a variety of services, supplies, and materials from other state agencies. These services and materials are detailed below for the fiscal year ended June 30, 2011:

Insurance	\$ 8,614
Warrant Writing Services	732
Payroll Services	4,575
Audit Fees	36,757
Computer Fees	35,797
Printing	944
State Accounting System Support	4,777
Supplies & Materials	7,760
Mail Processing Fees	7,678
Telecommunications	46,937
Vehicle Rental Fees	372
Administrative Service Fees	66,685
Other	982
TOTAL	\$ 222,610

4. PRIZES

Paid Prizes. Section 23-7-402, MCA states, "A minimum of 45% of the money paid for tickets or chances must be paid as prize money". Prize expense is recorded based on the predetermined prize structure percentage for each game less unclaimed prizes. For the quarter ended June 30, 2011, the prize expense of \$5,479,094 is 51.21% of net Lottery ticket revenue of \$10,698,295. For the year ended June 30, 2011, the prize expense of \$24,777,918 is 53.82% of net Lottery ticket revenue of \$46,035,296.

5. TRANSFER TO STATE GENERAL FUND

Section 23-7-402(3), MCA, states "That part of all gross revenue not used for payment of prizes, commissions, and operating expenses, together with the interest earned on the gross revenue while the gross revenue is in the enterprise fund, is net revenue. Net revenue must be transferred quarterly from the enterprise fund established by 23-7-401 to the State General Fund." For the year ended June 30, 2011, the net revenue payable to the State General Fund totaled \$2,892,772.

6. MULTI-STATE LOTTERY

In November 1989 the Montana State Lottery joined the Multi-State Lottery Association (MUSL). MUSL was created in September 1987 to operate a multi-state lottery game for the benefit of party lotteries. Powerball, Wild Card, Hot Lotto, and Mega Millions are the games jointly operated by the members, in which Montana presently participates. Each lottery participating in MUSL is represented on the Board of Directors.

The Multi-State Lottery Reserve Fund with a balance of \$1,688,570 and \$1,430,386 as of June 30, 2011, and 2010, respectively, is comprised of several reserve accounts, which are maintained by the Multi-State Lottery Association (MUSL). The balance of these reserve accounts and investment category is as follows:

June 30, 2011

	US <u>Treasury</u>	Federal <u>Agencies</u>	<u>Total</u>
Powerball Prize Reserve Account	\$ 412,996	\$ 269,530	\$ 682,526
Powerball Set Prize Reserve Account	103,249	67,383	170,632
Powerball Unreserved Account	98,457	64,255	162,712
Wild Card Prize Reserved Account	160,479	104,731	265,210
Hot Lotto Set Prize Reserve Account	216,079	141,018	357,097
Mega Millions Prize Reserve Account	<u>30,493</u>	<u>19,900</u>	<u>50,393</u>
Total	<u>\$1,021,753</u>	<u>\$ 666,817</u>	<u>\$1,688,570</u>

June 30, 2010

	US <u>Treasury</u>	Federal <u>Agencies</u>	<u>Total</u>
Powerball Prize Reserve Account	\$ 264,074	\$ 254,237	\$ 518,311
Powerball Set Prize Reserve Account	88,025	84,745	172,770
Powerball Unreserved Account	105,631	101,695	207,326
Wild Card Prize Reserved Account	119,019	114,585	233,604
Hot Lotto Set Prize Reserve Account	153,172	147,466	300,638
Mega Millions Prize Reserve Account	<u>(1,153)</u>	<u>(1,110)</u>	<u>(2,263)</u>
Total	<u>\$ 728,768</u>	<u>\$ 701,618</u>	<u>\$1,430,386</u>

The Powerball Prize Reserve Account is to be used only in the event of an unanticipated prize claim. It is an insurance fund intended to protect the member lotteries against the liability that could result from a system failure at one of the member lotteries. All money paid to this fund would be returned to the Lottery

one year after the Lottery leaves the Powerball game, assuming that no unanticipated prize claims have been paid. Interest earned on the Lottery's share of the fund, represented by the Unreserved Account, would be returned to the Lottery upon leaving MUSL. The amounts in the Unreserved Account may be used at the MUSL Board's discretion.

The Powerball Set Prize Reserve Account is used to fund prize payments for current drawings. Since the Powerball game has fixed prizes, it is often necessary to draw from this reserve to fund payment of prizes at the fixed amount. This account would be returned to the Lottery upon withdrawal from the Powerball Game.

The Lottery contributes to these reserve funds through the 50% set aside for prizes. In addition the Lottery was required to contribute for its portion of the reserve funds accumulated since the start of the Powerball game. Payments made to this fund are considered a portion of prize expense associated with the game.

The Wild Card Reserve Account is to be used in the event of an unanticipated prize claim on the Wild Card game. This account is also administered by MUSL and would be returned to the Lottery one year after the Wild Card Product Group of Idaho, Montana, South Dakota, and North Dakota is disbanded. The Lottery contributes to this account through the 55% set aside for prizes. Payments made to this fund are considered a portion of prize expense related to the Wild Card game.

The Hot Lotto Set Prize Reserve Account is administered by MUSL and is to be used only in the event of unanticipated prize claims. Like other MUSL games the reserve amount would be returned to the Lottery one year after withdrawal from the Hot Lotto game. The Lottery contributes to the reserve through the 50% set aside for prizes. Payments made to the reserve are considered a portion of the prize expense related to the game.

The Mega Millions Prize Reserve Account is to be used only in the event of an unanticipated prize claim. It is an insurance fund intended to protect the member lotteries against the liability that could result from a system failure at one of the member lotteries. All money paid to this fund would be returned to the Lottery one year after the Lottery leaves the Mega Millions game, assuming that no unanticipated prize claims have been paid. The Lottery contributes to the reserve through the 51% set aside for prizes. Payments made to the reserve are considered a portion of the prize expense related to the game. The Lottery had just started cross-selling Mega Millions during the fiscal year end 2010. As a start-up game, the reserve was negative at the year end as the Lottery had not

built up enough history and accumulated enough sales to create an excess reserve.

7. GAMES

Currently, the Montana Lottery games are scratch ticket games, seven lotto games referred to as Powerball, Montana Ca\$h, Wild Card, Hot Lotto, Mega Millions, 10 Spot, and Montana Millionaire, a limited edition lottery game. The lottery is facilitating Fantasy Sports Games on behalf of the Board of Horse Racing. Currently the Lottery is selling the Montana Sports Action Fantasy Football and the Racing games.

Scratch ticket games provide players the opportunity to win instantly by scratching latex covering to reveal a prize.

The Powerball game allows players the chance to win a minimum pari-mutuel jackpot of approximately \$20 million. A player must match all 6 numbers to win the jackpot; players win prizes ranging from \$3 to \$200,000 for matching less than all 6 numbers. Drawings are held twice weekly on Wednesday and Saturday nights. For any drawing, if no ticket matches 6 out of 6 numbers, the jackpot rolls over to the next drawing to create a progressive jackpot. In March 2001, the Lottery added Power Play to the Powerball game. For an additional bet, the Power Play option provides non-jackpot winners the chance to multiply their prize amount by a factor of two through five.

The Montana Ca\$h game allows players the chance to win a minimum pari-mutuel jackpot of \$20,000. Players select 5 numbers from a field of 37 and must match at least 3 out of 5 to win a prize. Matching 3 of 5 wins \$5 and 4 of 5 wins \$200. The drawing is conducted twice weekly on Wednesday and Saturday nights. If no ticket matches all 5 numbers, the jackpot rolls over to the next drawing to create a progressive jackpot.

The Wild Card game allows players the chance to win a pari-mutuel jackpot, with a guaranteed minimum of \$100,000. Players select 5 numbers from a field of 31 plus one of 16 face cards and must match all 5 numbers and the wild card to win the jackpot; players win prizes from \$1 to \$5,000 for matching less than all 5 numbers and/or the wild card. Drawings are held twice weekly on Wednesday and Saturday nights. If no ticket matches all 5 numbers and the wild card, the jackpot rolls over to the next drawing to create a progressive jackpot.

Hot Lotto allows players the chance to win a pari-mutuel jackpot with a guaranteed minimum of \$1 million. Players choose 5 numbers from a field of 39 plus 1 Hot Ball number from a field of 19; the first 5 numbers and the Hot Ball must be matched to win the jackpot. Players can win prizes ranging from \$2 to

\$10,000 by matching less than all 5 numbers and/or the Hot Ball. If no ticket wins the jackpot, it rolls over to the next drawing to create a progressive jackpot. Drawings are held twice weekly on Wednesday and Saturday nights. In January 2008, the Lottery added the Sizzler option to the Hot Lotto game. For an additional bet, the Sizzler option provides non-jackpot winners the chance to multiply their prize amount by three.

Mega Millions is a multi-state game that allows players to win a minimum pari-mutuel jackpot starting at \$12 million. Mega Millions went on sale March 1, 2010 in Montana. To win the jackpot, players must match all six numbers drawn; other prizes range from \$2 to \$250,000. Drawings are held each Tuesday and Friday. Mega Millions has a Megaplier option which multiplies non-jackpot prizes by two, three, or four. The Megaplier options costs \$1 extra per play.

10 Spot, which went on sale February 1, 2010, is a Montana-only, twice daily game. Players select ten numbers from one through eighty. The Lottery draws twenty numbers, and players win by matching ten, nine, eight, seven, six, five, or none of the numbers drawn. Prizes range from \$2 to \$25,000.

Montana Sports Action is a product line introduced by the Lottery in August 2008 on behalf of the Board of Horse Racing. Montana Sports Action Fantasy Football was the first game within the Fantasy Sports Games to begin. Players choose five eligible offensive players and a defensive unit from the official roster of professional football players and teams, to create their own team. The players then choose a play amount (\$5, \$10, \$20, \$50, or \$100) which determines the shares the player is eligible to win should their team have one of the three highest point totals for the week.

After completion of each week's professional football games, points are assigned to football players and defensive units based on their performance to determine the Lottery players' team's performance. Prizes paid must be 74% of sales for the week. How much the player wins is determined by their team's points and their share (\$5 per share). Ticket sales are allowed each week of the professional football season beginning Tuesday morning for that week's games with no advanced purchasing allowed.

Fantasy Racing was introduced in February 2009, and follows the NASCAR® Sprint Cup Series. Fantasy Racing teams are created by selecting a driver from the top nine-ranked drivers for the week; three drivers ranked from ten through 34; and one driver ranked 35 or above. The sixth element in a player's Fantasy Racing team is the number of yellow-flag cautions the player believes might occur in that week's race. Players also choose the number of shares they wish to buy (\$5, \$10, \$20, \$50 or \$100). Like Fantasy Football, the number of shares determines the amount of the prize each winning ticket will win. After each Sprint

Cup race, points are assigned to each driver's performance, and teams with the top three point totals win. Ticket sales begin each week on Monday.

Montana Millionaire began on November 1, 2009 with the final drawing on January 1, 2010. The tickets were sold sequentially across the state with 1 to 150,000 available. There were 400 - \$50 instant win prizes for every 375th ticket purchased. The final drawings were held on January 1, 2010 and consisted of one \$1 million dollar top prize, five \$100,000 prizes, and five \$10,000 prizes. This game will begin again on November 1, 2011 with the final drawing on approximately January 1, 2012. The number of tickets available will be 125,000 with an early bird prize of \$10,000 being awarded in late November.

8. COMMITMENTS - GAMING SUPPLIER CONTRACTS

Scratch Tickets. On June 27, 2008 the Montana Lottery Commission approved the award of a five-year contract with Scientific Games International (SGI) for the provision of scratch tickets. The contract is for five years with the option for two additional one-year renewals. The contract contains specifications regarding ticket design, printing, game ownership, inspection, and prize structure.

SGI, as the vendor, provided a performance bond covering the contract term and an errors and omissions policy covering an ultimate net loss of \$3,000,000. The Lottery may terminate this contract by providing proper notification to Scientific Games.

On-line Services. On October 11, 2005, the Lottery signed a seven-year contract with Intralot, Inc. of Duluth, GA to provide an on-line gaming system and the associated services beginning March 31, 2006. The contract requires Intralot to provide new terminals to all retailers with the associated software and communications. Payment under the contract is based on 5.8% of net weekly Lottery sales of lotto and scratch games. On August 18, 2008 an addendum was signed to provide services for the Fantasy Sports games at 3% of net weekly Lottery sales up to \$2,999,999 of Montana Sports Action games. The contract currently has a termination date of March 30, 2016.

9. LOTTO*AMERICA/POWERBALL/TRI-WEST JACKPOT PRIZES

Jackpot prizes awarded in the Lotto*America/POWERBALL and TRI-WEST LOTTO games are funded through the purchase of U.S. Treasury Zero-Coupon Bonds purchased in the name of the Montana Lottery by MUSL. MUSL will cash the bonds each year as they mature and will wire the funds to the Lottery for payment to winners on the Anniversary date of the win.

On January 13, 1990 the Montana Lottery awarded its first Lotto*America jackpot prize totaling \$1,740,000. The first annual payment of \$87,000 was made on February 1, 1990. On May 9, 1990 the Lottery awarded a second Lotto*America jackpot prize of \$3,000,000. The first annual payment of \$150,000 was made on May 23, 1990. A third jackpot prize was awarded on February 2, 1991 for \$7,360,000. The first annual payment of \$368,000 was made February 15, 1991. On November 23, 1991 a fourth jackpot prize was awarded totaling \$46,967,738.57. The first annual payment of \$2,355,738.57 was made December 12, 1991. On April 11, 1992 a fifth jackpot prize was won totaling \$2,000,000. The first annual payment of \$100,000 was made on April 27, 1992.

On July 6, 1994 the Montana Lottery awarded its first Tri-West Lotto jackpot prize totaling \$700,565. The first annual payment of \$35,000 was made on July 26, 1994.

On July 22, 1995 the Montana Lottery awarded its first Powerball jackpot prize totaling \$31,401,655.99. The first payment of \$1,571,655.99 was made on August 8, 1995. On April 5, 1997 the Lottery awarded a second Powerball jackpot prize totaling \$11,000,000. The first annual payment of \$550,000 was awarded on April 18, 1997.

On March 27, 1999 the Montana Lottery had a Powerball jackpot winner. The prize was \$35.1 million (\$19.35 million cash option). The winner chose the cash option and was paid a lump sum in June 1999.

On June 23, 2010 the Montana Lottery awarded its fourth Powerball jackpot prize. The total jackpot was \$96,856,406 and was split between another ticket in Ohio. Half of the jackpot, which was again split between two winners in Montana, totaled \$48.5 million (25.08 million cash option). The winners chose the cash option and were paid a lump sum in July 2010.

As of June 30, 2011, the combined total of future prize payments funded through the purchase of U.S. Treasury Zero-Coupon Bonds for Powerball and Tri-West Lotto winners was \$9,135,000. Total annual payments due as of June 30, 2011 are as follows:

<u>FYE</u>	
2012	\$ 2,155,000
2013	2,155,000
2014	2,155,000
2015	2,120,000
2016	550,000
	<u>\$ 9,135,000</u>

10. LEASES/INSTALLMENT PURCHASES PAYABLE

Rent. The Montana Lottery leases its office, administrative and warehouse facilities under a lease agreement that is effective September 2007 through August 2017. The monthly lease payment is \$11,099 through August 2011. The base rate will increase 3% annually.

Capital Lease. The Lottery has contracted with its vendor to lease equipment for the remaining life of its contract with them. Obligations under this capital lease/installment purchase at June 30, 2011 are as follows:

<u>FYE</u>	
2012	\$ 89,977
2013	85,827
2014	81,677
2015	77,528
2016	<u>55,423</u>
Total Minimum Payments	390,432
Less: Interest	<u>(47,635)</u>
Present value of Minimum Payments	<u>\$ 342,797</u>

11. INVESTMENT RISK DISCLOSURES

Effective June 30, 2005, the State of Montana implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures*. The Lottery participates in two investment pools: the Multi-State Lottery Association (MUSL) reserve accounts and the State of Montana's Short Term Investment Pool (STIP). There are four types of risk that must be disclosed. These risks are defined below, followed by their applicability to each of the investment pools.

Multi-State Lottery Association The MUSL investment policy for prize reserve and unreserved funds states that permitted investments "include direct obligations of the United States government, perfected repurchase agreements, and obligations issued or guaranteed as to payment of principal and interest by agencies or instrumentalities of the United States government, and mutual funds of approved investments".

Short-term Investment Pool All short-term funds are held in the State's Short Term Investment Pool (STIP) administered by the Board of Investments (BOI). STIP is an external 2a-7 like pool.

Credit risk is defined as the risk that an issuer of an investment will not fulfill its obligation, i.e., not make timely principal and interest payments. The STIP securities have credit risk as measured by major credit rating services, however, the pool is not rated. The Lottery does not have a policy regarding credit risk.

Per MUSL, the prize reserves held on behalf of the Montana Lottery are invested in the Montana Winners Trust and include 61% in securities held as obligations of the U.S. Government and are not considered to have credit risk. The other 39% of the prize reserves are invested in Federal Agencies and have an AAA credit quality rating. The Lottery does not have any authority or a policy regarding the investment portfolios.

Custodial credit risk is the risk that the Lottery would not be able to recover the value of the investment or collateral securities that are in the possession of an outside party in the event of the failure of that party. Custodial credit risk does not apply to STIP because it is a 2a-7 like pool.

The MUSL prize reserves are held in the Montana Winners Trust using policies set forth by the MUSL board regarding policies for the type of securities, as well as the custody, trading and the use of proceeds of the securities. The Lottery does not have any authority or a policy regarding the investment portfolios.

Concentration of credit is the risk of loss attributed to the magnitude of a government's investment in a single issuer. Because STIP is a pooled investment, this risk does not apply. Because the MUSL reserves are also a pooled investment, this risk does not apply to them either.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Interest rate risk does not apply to STIP because it is a 2a-7 like pool. The Lottery does not have any authority or a policy regarding the investment portfolios.

The MUSL prize reserves are invested through the Montana Winners Trust in the Morgan Stanley Government Portfolio Funds with daily liquidity and therefore have no interest rate risk. The MUSL board's investment policy limits the individual security and the portfolio's maturity. As of June 30, 2011, the duration for the U.S. Government Treasury securities was .916 years and for the Agency securities was 0.139 years.

12. EMPLOYEE RETIREMENT PLAN

All Lottery employees hired are, initially, members of the Public Employees Retirement System – Defined Benefit Retirement Plan (PERS-DBRP). PERS-

DBRP is a defined benefit cost sharing, multiple-employer public retirement system established on July 1, 1945 and governed by Title 19, chapters 2 & 3 of the Montana Code Annotated. This plan provides retirement, disability and death benefits to substantially all public employees and their beneficiaries not covered by another public plan.

New hires have a 12 month window during which they may choose to transfer to the Public Employees Retirement System – Defined Contribution Retirement Plan (PERS-DCRP) or remain in the current PERS-DBRP. Members may not be members of both plans. The choice is irrevocable. Members of the DCRP direct their contributions and a portion of their employer's contributions among the offered investment options. The remaining portion of their employer's contributions is used to reduce the Plan Choice Rate unfunded actuarial liability, to fund the long-term disability benefits to participants of the DCRP, and to fund an employee education program.

MONTANA STATE
LOTTERY

LOTTERY RESPONSE

April 27, 2012

Ms. Tori Hunthausen
Legislative Auditor
Office of the Legislative Auditor
State Capitol Building
Helena, MT 59620-1705

RECEIVED

MAY 04 2012

LEGISLATIVE AUDIT DIV.

Re: Response to 2011 Montana State Lottery Financial-Compliance Audit

Dear Ms. Hunthausen:

The Montana State Lottery appreciates the service your staff provided in reviewing the Lottery's procedures, internal controls, accounting practices and financial statements. The following is our response and action plan for the specific recommendations of the recent audit:

Recommendation #1

We recommend that the Lottery document its control system for monitoring the contractor's compliance with, and performance on, the advertising contract as required by state accounting policy.

We concur. The Montana Lottery has implemented a formal procedure in which controls are implemented and performance is documented during the monitoring of the Lottery's advertising contract. The process is outlined in Attachment A.

Annually the Lottery will audit the advertising contractor estimates, financial statements, and invoices to confirm best practices. As part of this report we will review the effectiveness of key controls and processes related to the contract fiscal reliability and then incorporate confirmed results that show positive controls into standard operating procedures for all future contracts as part of the RFP process.

Recommendation #2

We recommend that the Lottery:

- A. **Become more knowledgeable in application of state accounting policy through training and by incorporating state accounting policy into its policies.**
- B. **Record accounting transactions in accordance with generally accepted accounting principles as required by state law and state accounting policy.**

The Lottery concurs and has enrolled its key accounting personnel in a series of Government Accounting/Auditing Education Network classes. The classes will assist Lottery personnel in



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learning state accounting policy while reviewing current and new GAAP and GASB practices. The Lottery will also continue to ensure that accounting employees and other key staff members are provided the necessary training to maintain their knowledge of GAAP and keep them up to date with emerging accounting standards and guidance.

The Montana Lottery further recognizes that finding appropriate Accounting and Financial training results in uniform state practices which directly impacts the ability of the Lottery to accomplish its core mission of maximizing revenues for the State. In keeping with this understanding our Financial Service Director has conducted an analytical review of MOM Policy 399, specifically section V-VIII, and section XV, Appendix D. This Director has also used the assessment tool in section XIX to formulate improvements, set the direction for his section and provided employees with a clearly defined template of what is expected of them. We believe that providing this policy template is essential to our internal control framework and is one of the best ways to make sure everyone in accounting is "on the same page." This effort will also invariably result in well written policies and improvements to our internal controls and ensure the Montana Lottery stays in compliance with accounting principles as outlined by State law and accounting policies.

Recommendation #3

We recommend the Lottery:

- A. Document its financial statement preparation controls as required by state accounting policy, and
- B. Strengthen its financial statement preparation control system to prevent or detect and correct errors on the draft financial statements on a timely basis.

We concur. A process will be implemented to ensure documentation of Lottery's financial statement preparation and controls. A comprehensive checklist and a narrative process will be added to controls to sufficiently explain reasoning for any adjustments and to identify and correct possible errors on draft financial statements.

In addition, while the Department of Administration does review the Lottery's financial statements, a draft of the statements will be provided to the Department much sooner in the process so they have an extended period of time to accomplish a more comprehensive review.



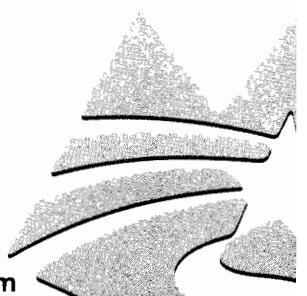
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B-3

Thank you for the opportunity to respond. We appreciate you and other members of your staff for the time you spent at the Montana Lottery. Your team was very professional and their comments and suggestions helpful.

Sincerely,


Angela Wong
Director
Montana Lottery



**Montana Lottery Financial-Compliance Audit
Management Action Plan
For Fiscal Year Ending June 30, 2011**

Audit Recommendation #	Lottery Response	Corrective Action Plan	Responsible Area	Target Date
No Documented Contract Monitoring Controls Recommendation #1	Concur	<p>The Montana Lottery has implemented a formal procedure in which controls are applied and performance is documented during the monitoring of the Lottery's advertising contract.</p> <p>* Attachment A.</p>	MT Lottery Marketing & Accounting	May-12
		<p>Annually the Lottery will audit the advertising contractor estimates, financial statements, and invoices to confirm best practices. As part of this evaluation we will review the effectiveness of key controls and processes related to the contract fiscal reliability and then incorporate confirmed result that show positive controls into standard operating procedures for all future contracts as part of the RFP process.</p>		Oct-12

<p>Accounting Records Recommendation #2</p> <p>We recommend that the Lottery:</p> <ul style="list-style-type: none"> A. Become more knowledgeable in application of state accounting policy through training and by incorporating state accounting policy into its policies. B. Record accounting transactions in accordance with generally accepted accounting principles as required by state law and state accounting policy. 	<p>Concur</p> <p>A & B. The Montana Lottery has enrolled its key accounting personnel in a services of Government Accounting/Auditing Education Network classes. The classes will assist Lottery personnel in learning state accounting while reviewing current and new GAAP and GASB practices. The Lottery will also continue to ensure that accounting employees and other key staff members are provided the necessary training to maintain their knowledge of GAAP and keep them up to date with emerging accounting standards and guidance.</p>	<p>In addition the Montana Lottery recognizes that finding appropriate Accounting and Financial training results in uniform state practices which directly impacts the ability of the Lottery to accomplish its core mission of maximizing revenues for the State. In keeping with this understanding our Financial Service Director has conducted an analytical review of MOM Policy 399, specifically section V-VIII, and section XV, Appendix D. This Director has also used the assessment tool in section XIX to formulate improvements, set the direction for his section and provided employees with a clearly defined template of what is expected of them. We believe that providing this policy template is essential to our internal control framework and is one of the best ways to make sure everyone in accounting is "on the same page." This effort will also invariably result in well written policies and improvements to our internal controls and ensure the Montana Lottery stays in compliance with accounting principles as outlined by state law and state accounting policies.</p>	<p>MT Lottery Accounting</p>	<p>Jul-12</p>
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**Montana Lottery Financial-Compliance Audit
Management Action Plan
For Fiscal Year Ending June 30, 2011**

Financial Statements Recommendation #3 We recommend the Lottery:	Concur	<p>A. A process will be implemented to ensure documentation of Lottery's financial statement preparation and controls. A comprehensive checklist and a narrative process will be added to controls to sufficiently explain reasoning for any adjustments and to identify and correct possible errors on draft financial statements.</p> <p>B. While the Department of Administration does review the Lottery's financial statements, Lottery will strengthen its preparation control system by providing its draft financial statements to the Department much sooner in the process so they have an extended period of time to accomplish a more comprehensive review.</p> <p>A. Document its financial statement preparation controls as required by state accounting policy, and</p> <p>B. Strengthen its financial statement preparation control system to prevent or detect and correct errors on the draft financial statements on a timely basis.</p>	MT Lottery Accounting, Department of Administration	Jul-12
				June-12

